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FACT SHEET: Accelerated Depreciation

As policymakers debate comprehensive tax reform, discussions have focused on potential changes to methods by which manufacturers recover their capital costs. In particular, proposals to repeal accelerated depreciation methods and replace them with other cost recovery methods have been discussed as a way to finance an overall corporate tax rate reduction. AFPM strongly opposes the repeal of accelerated depreciation. AFPM encourages policymakers to consider the impacts on domestic manufacturing jobs and economic growth from the repeal of accelerated depreciation when judging the trade-offs between base-broadeners and rate reduction in comprehensive tax reform.

What is Accelerated Depreciation?

- Accelerated depreciation is one of several cost recovery methods that businesses are permitted to use for financial accounting or tax purposes. Accelerated depreciation permits recovery or deduction of the costs to acquire or produce fixed assets in a manner such that the amount deducted each year is higher during the earlier years of an asset's useful life.

- Accelerated depreciation mitigates the harmful effects on a business's after-tax cash flow caused by an income tax system that deviates from a consumption basis. Accelerated depreciation moves the tax system closer to a consumption basis, which most economists agree is the best system for reducing business's after-tax cost of investing in machinery and equipment needed to expand and grow their operations.

Background

- Under both financial accounting and tax accounting, corporations generally do not claim the entire cost of a capital asset as an expense deduction immediately. The corporation depreciates (i.e., deduct over a period of years) the cost of the asset over some period, usually an approximation of the useful life of the asset for financial accounting and over periods prescribed by the IRS for tax accounting purposes.

- Tax accounting rules are designed to establish a base of taxable income for a single taxable period. Opinions differ on whether that base should hew closely to financial accounting principles or instead be based more on cash flow, i.e. a consumption basis. The current tax code is a hybrid of the two views. Rarely does the capital cost recovery rules of the tax code adhere to those of financial accounting. In fact, many costs that would be capitalized for financial accounting purposes are simply expensed for tax purposes. Accelerated depreciation for investments in machinery and equipment is a compromise between full expensing and financial accounting recovery life.

- In the U.S., the two current allowable depreciation systems for accelerated depreciation are the Accelerated Cost Recovery System (ACRS) and the Modified Accelerated Cost Recovery System (MACRS). Under these provisions, the useful life of the capital asset is determined by looking at Section 168(e)(3) of the U.S. Tax Code, and is known as the class life of the property. Section 168(e)(3) provides a table for determining the applicable recovery period and the depreciation method.

- The modified accelerated cost recovery system (MACRS), created after the release of the Tax Reform Act of 1986, is a long standing method of depreciation that substantially reduces the risk premium and hurdle rate to make new investments more attractive. As stated at that time, an efficient and

competitive "capital cost recovery system is essential to maintaining U.S. economic growth. To that end, over the past decade, Congress allowed and has repeatedly renewed faster depreciation of capital assets to stimulate business investment by providing a "bonus" depreciation allowance in the year the asset is placed in service.

- Most types of tangible property (except land), such as buildings, machinery, vehicles, furniture, and equipment are depreciable. Likewise, certain intangible property, such as patents, copyrights, and computer software are depreciable.

How does depreciation work?

- Assume that a refinery purchases a piece of equipment on July 1 that costs $1,000. For simplicity, assume that the depreciable life is 10 years regardless of the depreciation method used.

- Under MACRS accelerated depreciation, the refinery depreciation is higher in the early years than under the straight-line method, offset by lower depreciation in the later years than under the straight line method. Note: Both straight line and MACRS results in $1,000 of depreciation over the life of the asset.

Calendar Year	Straight Line Depreciation	Calendar Year	MACRS
1	$ 50	1	$100
2	$100	2	$180
3	$100	3	$144
4	$100	4	$115
5	$100	5	$ 92
6	$100	6	$ 74
7	$100	7	$ 66
8	$100	8	$ 66
9	$100	9	$ 65
10	$100	10	$ 65
11	$ 50	11	$ 33

  - In this example, over the first three years of the life of the asset accelerated depreciation provides the business with $66 in more cash per $1,000 of investment made that is then available to the business to re-invest in new more-efficient and productive assets – thereby helping to drive U.S. economic growth.

Conclusion

Congress should reject calls to repeal accelerated depreciation in favor of methods that allow a slower recovery of investment costs. Accelerated depreciation is a long-standing method of depreciation that has had a positive impact business' near-term on cash flow, which is an important determinant in the level of investment in new equipment. Studies have shown that a change to slower methods of depreciation will increase the cost of capital and the cost of new equipment, a change that will result in lower capital investment by U.S. businesses and fewer U.S. jobs.